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IN THE

Supreme Court of the United States

October Term—1962

In the Matter
of
DUTCHER CONSTRUCTION CORPORATION,
Bankrupt.

PETITION FOR A WRIT OF CERTIORARI TO REVIEW AN ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT AFFIRMING AN ORDER OF THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF NEW YORK.

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Cases Cited

Statutes

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The petition of CHESTER A. PEARLMAN, Trustee in Bankruptcy of Dutcher Construction Corporation, respectfully shows:

(A) The opinion of the United States District Court for the Western District of New York is reported in 197 Fed. Supp. 441. The opinion of the United States Court of Appeals for the Second Circuit has not been reported.

(B) The jurisdiction of this court is invoked.

(1) The judgment of the United States Court of Appeals for the Second Circuit, which is sought to be reviewed, was entered on February 6, 1962, in the office of the Clerk of that court.

(2) The statutory provision believed by petitioner to confer on this court jurisdiction to review the judgment in question by writ of certiorari is that the United States Court of Appeals for the Second Circuit has rendered a decision in conflict with the decision of the United States Court of Appeals for the Tenth Circuit and the decision of the United States Court of Appeals for the Ninth Circuit, and the United States Court of Appeals for the Second Circuit has further decided a federal question in a way which is in conflict with the applicable decision of this court.

(C) The question presented for review is whether the Reliance Insurance Company, which paid certain laborers and materialmen for services and materials furnished to the Dutcher Construction Corporation prior to that corporation's bankruptcy, is entitled to be paid prior to general creditors of the bankrupt Dutcher Construction Corporation, the monies earned by Dutcher Construction Corporation prior to its bankruptcy and paid over by the United States of America subsequent to said bankruptcy to the Trustee in Bankruptcy of Dutcher Construction Corporation.

(D) The facts material to a consideration of the questions presented are as follows:

The bankrupt Dutcher Construction Corporation executed a contract with the United States Corps of Engineers for certain construction on the St. Lawrence Seaway and furnished to the Corps payment and performance bonds, both issued by the Fire Association of Philadelphia, now named the Reliance Insurance Company. This was done on or about April 11, 1955, and was pursuant to the Miller Act, 40 U. S. C. A., Secs. 270A-270D.

The bankrupt entered into performance of its contract with the Corps of Engineers and incurred bills for labor and materials which were covered by the payment bond issued by the surety company. The bankrupt never defaulted in the performance of the contract so far as the Corps of Engineers was concerned, but the contract between the bankrupt and the Corps was terminated on April 11, 1956, for the convenience of the Corps and with the consent of the bankrupt.

When the contract was terminated, the bankrupt had completed a very substantial part of the contract but it had run out of money and left approximately $326,248.42 of unpaid bills covered by the payment bond. These the surety proceeded to pay pursuant to the terms of the obligation of the payment bond. The surety further claims that it has expenses in connection with said payments of $20,754.34 and other payments of $22,924.99. The bills were paid by the surety in the spring and summer of 1956, and at the end of August, 1956, Dutcher Construction Corporation was adjudicated a bankrupt.

Subsequent to the termination of the contract with the Corps of Engineers, the Corps with the consent of the bankrupt corporation awarded the unfinished portion of the Dutcher contract to a joint venture of several corporations which agreed with the United States Corps of Engineers to complete the same at the Dutcher Construction Corporation prime contract price.

The joint venturers also agreed that they would do certain of the work which had been left unfinished by the bankrupt corporation for the sum of $40,000.00, said $40,000.00 to be a charge against the sum of $127,737.35 earned by the bankrupt and retained by the Corps of Engineers at the time of the termination of the bankrupt's contract.

Neither the Trustee nor the surety objected to this sum being taken from the Dutcher prime contract monies and, in fact, they agreed that this was a fair price to pay the joint venturers for the completion of the contract which should have been done by the bankrupt corporation. The joint ventures did complete their work and were paid $40,000.00, leaving a balance retained by the United States in the sum of $87,737.35. This sum was thereafter paid to the Trustee.

It is this sum of $87,737.35 to which the surety company asserts it has a right which is prior to the rights of the general creditors of the bankrupt corporation.

(E) The basis for federal jurisdiction in the court of first instance is that this is a matter involving a bankrupt corporation and its creditors.

(F) The United States Court of Appeals for the Second Circuit has ruled under the circumstances set forth above, that the surety, Reliance Insurance Company, is entitled to the fund paid by the United States of America to the Trustee in Bankruptcy. The court in its opinion admittedly has disagreed with the decisions of the United States Court of Appeals for the Ninth and Tenth Circuits and has stated in its opinion, per Medina, Circuit Judge, at page 68 of the record:

> "With all due respect to our brothers of the 9th and 10th Circuits, we believe they have misconstrued the Supreme Court decision in *United States v. Munsey Trust Company*, 1947, 332 U. S. 234, and we disagree with the decisions in those Circuits holding the surety not entitled to subrogation. *Phoenix v. Earle*, 9 Cir. 1955, 218 F. 2d 645; *American Surety Co. v. Hinds*, 10 Cir., 1958, 260 F. 2d 366."

Moreover, the United States Court of Appeals for the Second Circuit, after pointing out the reliance of the

United States Court of Appeals for the Ninth and Tenth Circuits upon certain language of the United States Supreme Court, in *United States v. Munsey*, 1947, 332 U. S. 234, has gone on to state that those courts have misconstrued the *Munsey* case, as witness the following quotation from the opinion on the United States Court of Appeals for the Second Circuit, at page 73 of the record:

> "In any event, we think the quotations from *Munsey* in the opinions in *Phoenix* and *Hinds* have been misconstrued."

And finally, the United States Court of Appeals, Second Circuit, after citing certain cases which preceded the decision of the United States Supreme Court, in *United States v. Munsey Trust Co., supra* has stated at page 74 of the record:

> "It is inconceivable to us that the Supreme Court intended in *Munsey* to overrule *sub silentio* the rules of priority and subrogation that, as we have already pointed out, were so well established under the Heard Act. Certainly, there is not the slightest intimation that anything in the Miller Act was intended to change priorities existing under the prior legislation. See *United States v. Aetna Casualty & Surety Co.*, 2 Cir., decided January 11, 1962, Slip Sheet, at page 622. Accordingly, we disagree with *Phoenix* and *Hinds*."

Accordingly, there now exist decisions of the Ninth and Tenth Circuits which are in complete conflict with the Second Circuit in matters frequently before the United States Courts. As a matter of fact, a brief supporting the position of the petitioner was filed by counsel from Fort Worth, Texas, in the Fifth Circuit as *amicus curiae*, and a further memorandum was filed by counsel from Phoenix, Arizona, in the Ninth Circuit, as *amicus curiae* in this matter when it was before the United States Court of Appeals for the Second Circuit. Each of the counsel was concerned in a

matter involving the same legal question and very similar facts.

Since the decision of the United States Court of Appeals for the Second Circuit, the referee in bankruptcy of the United States District Court for the Northern District of Texas has rendered an opinion in *Stanford Construction Co.*, Bankrupt, in conformity with the *Hinds* case, *supra*, decided in the Tenth Circuit, and the *Phoenix* case, *supra*, decided in the Ninth Circuit. That decision is completely opposed to the decision herein which decision the referee specifically refused to follow.

The Trustee in Bankruptcy, therefore, contends that there should be a review of the judgment of the United States Court of Appeals for the Second Circuit on the ground that a matter of law only is involved and,

(1) There is a conflict between the decision of the United States Court of Appeals for the Second Circuit and the decisions of the United States Courts of Appeals for the Ninth and Tenth Circuits; and

(2) The basis for the conflict is the construction of the decision of the United States Supreme Court, in *United States* v. *Munsey Trust Co.*, 332 U. S. 234.

WHEREFORE, petitioner, CHESTER A. PEARLMAN, Trustee in Bankruptcy of Dutcher Construction Corporation, respectfully prays that this court issue a writ of certiorari to review the decision of the United States Court of Appeals for the Second Circuit.

CHESTER A. PEARLMAN,
Trustee in Bankruptcy of
Dutcher Construction Corporation.

By LOWELL GROSSE,
Counsel for Petitioner.

Appendix

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 197—September Term, 1961.

(Argued January 19, 1962 Decided February 6, 1962.)

Docket No. 27246

In the Matter
of
DUTCHER CONSTRUCTION CORPORATION,
Bankrupt.

Before: MEDINA, MOORE and SMITH, *Circuit Judges.*

Appeal from an order of the United States District Court for the Western District of New York, in bankruptcy, John O. Henderson, *Judge.*

The trustee in bankruptcy appeals from an order directing him to pay to petitioner, Reliance Insurance Company, $87,737.35, a fund previously paid to the trustee by the United States for work performed by the bankrupt on its prime Government contract prior to the termination of said contract by mutual consent on April 11, 1956. The payment was directed on the basis of the subrogation of Reliance Insurance Company to priority rights of materialmen and laborers, who had been paid by Reliance Insurance Company pursuant to the terms of its payment bond, upon

the failure of the bankrupt to make such payments when due. Opinion below reported at 197 F. Supp. 441. Affirmed.

Raymond T. Miles, Buffalo, New York, for appellant, Chester A. Pearlman, Trustee in Bankruptcy of Dutcher Construction Corporation.

Mark N. Turner, Buffalo, New York (Vaughan, Brown, Kelly, Turner, & Symons, Buffalo, New York, on the brief), for respondent, Reliance Insurance Company.

John G. Street, Jr., Fort Worth, Texas, filed a brief as *amicus curiae* supporting the contentions of appellant.

Thomas W. Murphy, Phoenix, Arizona (Murphy & Mirkin, Phoenix, Arizona), filed a memorandum as *amicus curiae* supporting the contentions of appellant.

MEDINA, *Circuit Judge:*

The trustee in bankruptcy of Dutcher Construction Corporation appeals from an order of Judge Henderson, reversing the Referee and holding that petitioner-appellee Reliance Insurance Company (formerly named Fire Association of Philadelphia) was entitled to a fund of $87,737.35 previously paid by the Government to the trustee. Opinion below reported at 197 F. Supp. 441.

The case is interesting and important, as it involves the controversial question of whether a surety, having paid materialmen and laborers pursuant to the terms of a payment bond, but not having completed performance of work required by the prime contract with the Government, is entitled by way of subrogation to the fund paid to the trustee in bankruptcy by the Government for the work done by the contractor prior to the termination of the

contract. We think the legal principles formulated by the courts on this subject under the Heard Act, 28 Stat. 278 (1894), amended 33 Stat. 811 (1905), were not affected or altered by the Miller Act, 49 Stat. 793 (1935), 40 U. S. C. Section 270a, which superseded the Heard Act. With all due respect to our brothers of the 9th and 10th Circuits, we believe they have misconstrued the Supreme Court decision in *United States v. Munsey Trust Company*, 1947, 332 U. S. 234, and we disagree with the decisions in those Circuits holding the surety not entitled to subrogation. *Phoenix v. Earle*, 9 Cir., 1955, 218 F. 2d 645; *American Surety Co. v. Hinds*, 10 Cir., 1958, 260 F. 2d 366.

The facts are stipulated. In April of 1955 Dutcher contracted with the United States to perform work on the Saint Lawrence Seaway project. Prior to awarding the contract, the Government required Dutcher to supply the customary surety bonds, a performance bond and a payment bond. This was done pursuant to the Miller Act, 40 U. S. C. Section 270a, which provides:

> "Before any contract, exceeding $2,000 in amount, for the construction, alteration, or repair of any public building or public work of the United States is awarded to any person, such person shall furnish to the United States the following bonds, which shall become binding upon the award of the contract to such person, who is hereinafter designated as 'contractor':
>
> (1) A performance bond with a surety or sureties satisfactory to the officer awarding such contract, and in such amount as he shall deem adequate, for the protection of the United States.
>
> (2) A payment bond with a surety or sureties satisfactory to such officer for the protection of all persons

supplying labor and material in the prosecution of the work provided for in said contract for the use of each such person."

Reliance is the surety on these bonds.

On April 11, 1956 the Government, with the consent of Dutcher, terminated the contract. During the preceding year Dutcher incurred obligations to pay for labor and materials in the perforamnce of the contract. Dutcher did not meet these obligations. The surety did pay them, in the amount of $326,248.42, for labor and materials, and additional sums for expenses, and in satisfaction of a judgment against the surety for tires furnished for use on the job, amounting in all to $349,172.81. These bills were paid by the surety in the Spring and Summer of 1956. At the end of August, 1956 Dutcher was adjudicated bankrupt.

Prior to the termination of the contract, Dutcher had earned, after Government deductions, $127,737.35 for the work done up to that time, and this represented the labor and materials that had gone into the job. This sum, owing to Dutcher, was reduced by $40,000, the cost to the Government of completing the job. This consisted of the proper shaping and dressing of the spoil area. The balance, $87,737.35, was paid by the Government to appellant, as Trustee for Dutcher. The surety petitioned for an order in bankruptcy directing the transfer of this fund to the surety. The Referee, relying upon *Munsey* and the *Hinds* decision by the 10th Circuit denied the petition, and Judge Henderson reversed the Referee and held the surety entitled to the fund by subrogation. We affirm.

All parties agree that the surety is subrogated to the rights of the laborers and materialmen. What this entitles the surety to is hornbook law and is set forth in Osborne, Suretyship (1955) at page 20, "It • • • entitles the surety

to enjoy any priority that the creditor enjoyed." See also Restatement, Security § 141, comment c. (1941). Thus, the only question in this case, and the decisive one, is—were the laborers and materialmen entitled to a priority in the $87,737.35?

Under the Heard Act

The Heard Act required a contractor entering on the construction of any public work for the United States shall "execute the usual penal bond, with good and sufficient sureties, with the additional obligations that such contractor or contractors shall promptly make payments to all persons supplying him or them labor and materials in the prosecution of the work provided for in such contract." 33 Stat. 812 (1905). In *Henningsen v. U. S. Fidelity & Guaranty Co.*, 1907, 208 U. S. 404, the surety which had paid materialmen and laborers upon the contractor's failure to do so, claimed a fund due from the Government as against a creditor of the contractor who held an assignment. It was argued by the creditor that the surety had no right prior to the assignment as the materialmen and the laborers had no lien on the Government property under construction, as the contractor and not the surety had completed performance under the contract, and as the materialmen and the laborers never had any right to the fund. In rejecting these contentions the Supreme Court held, 208 U. S. at page 410:

> "It [the surety] paid the laborers and material-men and thus released the contractor from his obligations to them, and to the same extent released the Government from all equitable obligations to see that the laborers and supply men were paid. It did this not as a volunteer but by reason of contract obligations entered into before the commencement of the work."

This would seem to be plain enough. But *Henningsen* was commented upon in *Belknap Hardware & Mfg. Co. v. Ohio River Contract Co.*, 6 Cir., 1921, 271 Fed. 144, and the priority of materialmen and laborers spelled out in no uncertain terms, at pp. 148-9:

> "In that case [Henningsen], the surety upon a bond of this kind [a payment bond], given pursuant to the 1894 statute, and who had been compelled to pay its surety obligation, was held entitled to priority in the retained fund as against a general creditor of the contractor. * * * The surety's claim of priority in the fund was sustained, and this was done on the stated theory of subrogation. Since there cannot be the transfer of a right by subrogation, unless there is a right to be transferred, we think the necessary effect of the decision is to hold that the laborers and materialmen, in spite of or in addition to the giving of the bond, had an original and continuing equitable priority in the fund, and that it was this right to which the surety was subrogated."

The Miller Act

It is common knowledge that difficulties and inconveniences arose in the application of the Heard Act. For example, the unpaid materialmen and laborers had to wait until six months after the completion and final settlement of the contract before they could proceed against the surety. If the Government instituted suit earlier, the laborers and materialmen could intervene, but shared only in the balance, if any, of the surety's liability remaining after the amount due the Government was paid in full. The legislative history of the Miller Act indicates clearly that the separate performance and payment bonds in their present form were substituted for the old law for the further

protection of materialmen and laborers. See 79 Cong. Rec. 11702 (1935) (remarks of Representative Miller); 79 Cong. Rec. 13382 (1935) (remarks of Senators Burke, Walsh and McCarran). There is nothing to indicate that the priorities of the materialmen and laborers were intended to be eliminated, or affected in any way by the new provisions of the Miller Act. Under the Heard Act, and under the Miller Act as well, the security for the materialmen and laborers was to stand in place of a lien on the property under construction, as no lien attaches to Government property. The purpose under each of these Acts was the same, to encourage laborers and those furnishing materials to undertake the construction of the Government facility, and to make sure that those who did so and created the product under construction should be secured out of the job itself rather than on the general credit of the prime contractor.

It follows we think that the same priorities held to exist under the Heard Act continue to exist under the Miller Act. If the Government was under "equitable obligations to see that the laborers and supply men were paid" (208 U. S. at page 410), this would seem sufficient to support the claim of the surety for priority, and such "equitable obligations" surely are not less under the Miller Act than they were under the Heard Act. In this context we think it quite immaterial that, after the termination of the contract, the little that remained to be done to complete the job was not done by the surety.

United States v. Munsey, 1947, 332 U. S. 234.

The decisions of the 9th and 10th Circuits in *Phoenix* and *Hinds* above referred to are based squarely on the premise that the Supreme Court in *Munsey* had sustained the Government's claim to a set-off partly because of "the weak-

ness of the surety's claim to equitable rights in the fund." See *Hinds*, 260 F. 2d at page 368. Perhaps this impression stems from the following dictum in *Munsey*, 332 U. S. at page 242:

> "We need not decide whether laborers and materialmen would have any claim to the retained percentages if both contractor and surety failed to pay them. Even if they do, certainly those would be rights to which the surety could not be subrogated, for by hypothesis it would have done nothing to earn subrogation."

In any event, we think the quotations from *Munsey* in the opinions in *Phoenix* and *Hinds* have been misconstrued. If the Supreme Court intended to make any comment with respect to the situation now before us, it was merely to say they held the point open for decision in the future. Of course, if the surety failed to pay materialmen and laborers, the surety "would have done nothing to earn subrogation." Moreover, the fact that "laborers and materialmen have no enforceable rights against the United States," 260 F. 2d at page 368, is beside the point. The question is not whether the laborers and materialmen have rights enforceable against the Government, but whether they have an equitable priority in the retained payments.

In *National Surety Corporation v. United States*, Ct. Claims, 1955, 133 F. Supp. 381, cert. denied *sub nom. First National Bank in Houston v. United States*, 1955, 350 U. S. 902, the Court said at page 384:

> "[T]he laborers and materialmen have the equitable right to assert a claim to moneys in the hands of the defendant [the United States] which are due to contractor. When the surety pays the laborers and materialmen, it becomes subrogated to their right to assert an equitable claim to the moneys in the hands of the

defendant. It has frequently been held that they have equitable priority to these moneys over the general creditors of the contractor and over his assignees. [Numerous citations omitted.]

* * *

In *United States v. Munsey Trust Co., supra*, the Supreme Court said that the United States was not legally liable to laborers and materialmen, but it did not say that laborers and materialmen could not assert an equitable claim to moneys in the hands of the United States payable under the contract. We think they can. To permit them to do so in no way interferes with the full exercise of the sovereign powers of the United States. It does not subject the defendant to liability beyond the amount it has in its hands confessedly due and owing to somebody."

Royal Indemnity Co. v. United States, Ct. Claims, 1950, 93 F. Supp. 891, is to the same effect.

The principle established by *Munsey* was that the Government's right to a set-off based on sums due from the contractor on other jobs was superior to any claim of the surety by way of subrogation. Furthermore, there is language in *Munsey* that justifies, if not compels, it to be limited to situations in which the United States is asserting a claim of its own to the retained funds. There are cases that have so held. *E. g. Royal Indemnity Co. v. United States, supra; United States Fidelity & Guaranty Co. v. Triborough Bridge Authority*, 1947, 297 N. Y. 31; and cases cited in *Hinds*, 260 F. 2d at 368.

It is inconceivable to us that the Supreme Court intended in *Munsey* to overrule *sub silentio* the rules of priority and subrogation that, as we have already pointed out, were so well established under the Heard Act. Certainly, there is

not the slightest intimation that anything in the Miller Act was intended to change priorities existing under the prior legislation. See *United States v. Aetna Casualty & Surety Co.*, 2 Cir., decided January 11, 1962, Slip Sheet, at page 622. Accordingly, we disagree with *Phoenix* and *Hinds*.

We hold the surety entitled to the fund by subrogation; and the order appealed from is affirmed.